Feature

Longevity swaps: myths versus reality

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Longevity swaps can offer pension schemes an effective way to reduce a key risk, but they face some popular misconceptions. We aim to correct these, showing that longevity swaps can offer clear benefits for pension schemes.

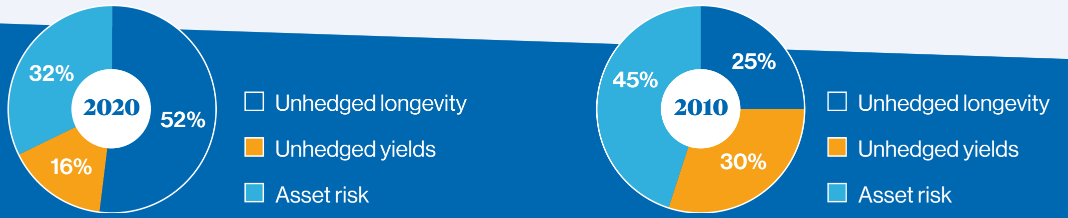
What are longevity swaps?

Longevity swaps are agreements that aim to help pension schemes reduce longevity risk. Longevity risk is the impact on a pension scheme of pensioners living longer than expected, resulting in paying pensions for longer and the need to manage risk for longer than anticipated.

Under the terms of the longevity swap contract, a scheme makes a series of agreed monthly or quarterly 'fixed' cashflows payments to the reinsurer, typically over the next 40 to 50 years. These payments will reflect an agreed best-estimate projection of the pensions due to the insured population and will be linked to inflation much as the scheme benefits may be. They will also include the reinsurer's fee for taking on the longevity risk.

In return, the scheme receives payments from the reinsurer equal to the actual pensions due to the insured population, which will vary depending on the realised longevity experience of the individual lives. As a result, ~~he~~ pension scheme is no longer exposed to the risk of the insured population living longer than expected. In practice, reinsurers can only transact with insurers, so pension schemes wishing to hedge longevity risk must do so via an insurer.

Fig. 1: Longevity risk is now the largest unhedged risk for the average UK pension scheme



Source: Club Vita, April 2021. Based on information in the Pension Regulator's Scheme Funding Analysis 2020 and 2010 and the PPF's Purple Books, approximately converted. Figures show the drivers that would increase the deficit in the average of the worst 5% (1 in 20) outcomes.

Myth 1? – Longevity risk is not a significant risk

Reality – Longevity risk now represents a substantial proportion of the total risks facing the average pension scheme. Other risks, such as interest rate risk and inflation risk, have largely been hedged.

Over the last 10 to 15 years, most pension schemes have reduced their exposure to growth assets and have hedged material amounts of interest rate and inflation risk but left longevity risk largely unhedged. According to the latest-available analysis by Hymans Robertson, of the remaining risk faced by pension schemes in 2020, more than half (52%) was posed by unhedged longevity. Ten years previously, it was only a quarter of the risk.

Myth 2? – Longevity swaps are complex and difficult to implement

Reality – Although they can be ~~time consuming~~ to set up, increasing standardisation is making the longevity swap implementation process and ongoing administration less complex.

Implementation is generally simpler today than in many earlier cases, as structures become more standardised and straightforward. Using a previously executed contract as a starting point for contract drafting can help in most transactions and contributes to developing consistency and standardisation. After initial set-up, regular management need not be onerous for the pension scheme, with much of it typically delegated to the scheme administrator.

Myth 3? – Longevity swaps are expensive

Reality – The costs associated with setting up and administering longevity swaps should be viewed alongside the potential costs of a negative longevity shock, which may be substantially greater.

Longevity swap agreements carry some initial set-up costs, as with any similar transaction, but thereafter, on an ongoing basis, the main cost associated with a longevity swap will be the risk fee payable to the reinsurer. For a pensioner-only transaction (where deferred liabilities are not included), the risk fee will typically be in the region of 3% to 4% of the projected pension cashflows. Broadly speaking, this will equate to an increase in the required rate of return from the assets backing those pensioner liabilities of approximately 0.25% to 0.33% per annum (pa). (This estimate assumes the fee is spread over a duration of the pensioner liabilities of about 12 years).

Myth 4? – Longevity swaps are only for the largest schemes

Reality – Although the average size of publicly announced longevity swaps has increased to more than £3bn in recent years, we believe that we will see more medium-sized schemes transact in the market as it continues to develop and grow. We understand that the majority of longevity reinsurers would consider transactions from around £300m upwards, suggesting that smaller transactions are potentially viable.

Myth 5? – Longevity swaps are a barrier to buy-in

Reality – Developments in the novation of longevity swaps mean that future conversion to a buy-in does not need to be a hurdle preventing schemes from hedging their longevity risk today.

As the process of novating longevity reinsurance agreements becomes more familiar for the key participants such as insurers, reinsurers, consultants, and lawyers, we expect a steady flow of such conversions each year. Converting a longevity swap to a buy-in entails three primary actions, all of which must take place simultaneously:

- The pension scheme terminates the longevity insurance agreement it has with the insurer.
- The pension scheme sets up a new buy-in insurance policy with a buy-in insurer.
- The longevity reinsurance agreement is novated to stand between the reinsurer, the new buy-in insurer.

Myth 6? – Longevity swaps only cover the lower-risk pension members

Reality – Reinsurers are increasingly willing to provide coverage to non-pensioner members, who in some cases will represent the majority of a scheme's longevity risk.

To date, two publicly announced transactions have included non-pensioner members: the AXA UK Group Pensioner Scheme (95% non-pensioner) and UBS (UK) Pension and Life Assurance Scheme (50% non-pensioner). We expect to see more such transactions in the coming years.